Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 93-215
	)	
and	)	
	)	
Adoption of a Uniform Accounting System for Provision of Regulated Cable Service	)	CS Docket No. 94-28

SECOND REPORT AND ORDER, FIRST ORDER ON RECONSIDERATION, AND FURTHER NOTICE OF PROPOSED RULEMAKING

Adopted: December 15, 1995 Released: January 26, 1996

By the Commission:

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Paragraph:

I. INTRODUCTION

1. In this *Second Report and Order, First Order on Reconsideration, and Further Notice of Proposed Rulemaking*, we adopt final rules governing standard cost of service showings filed by cable operators seeking to justify rates for regulated cable services. We also seek comment on two aspects of these rules.

2. Pursuant to the Cable Television Consumer Protection and Competition Act of 1992 (the "1992 Cable Act"),[1] the Commission has promulgated rules to ensure the reasonableness of rates charged by regulated cable operators for their basic service tiers ("BSTs") and cable programming service tiers ("CPSTs").[2] A cable system is subject to rate regulation if it does not face effective competition in the franchise area it serves.[3] Regulatory authority over rates charged by cable operators is divided between local franchising authorities and the Commission. The local franchising authority has primary authority to regulate a cable system's BST rates, once the authority has been certified by the Commission to regulate rates.[4] The BST must include, at a minimum, all local broadcast stations carried by the cable operator and all public, educational and governmental access programming required under the terms of the cable operator's franchise.[5] The Commission regulates CPST rates directly, upon the filing of a valid complaint.[6] The CPST includes any tier of programming, other than the BST, offered by the operator.[7] Per-channel and per-program offerings are generally not subject to rate regulation.

3. The primary scheme for establishing initial rates for cable service employs a benchmark formula designed to ensure that an operator's regulated rates do not exceed what the operator would charge if it faced effective competition.[8] Under the benchmark approach, most regulated cable operators were required to reduce their regulated rates to a level that represented their September 30, 1992 regulated revenues reduced by a 17% competitive differential (adjusted for annual inflation increases, changes in external costs

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[1] Cable Television Consumer Protection and Competition Act ("1992 Cable Act"), Pub. L. No. 102-385, 106 Stat. 1460 (1992).

[2] Sections 623(b), (c) of the Communications Act of 1934, as amended ("Communications Act").

[3] *Id.* at § 623(a)(2); *see id.* at § 623 (l)(1) (defining "effective competition").

[4] *Id.* at § 623(a)(2)(A); *see id.* at § 623(a)(3) (certification of franchising authorities to regulate rates).

[5] *Id.* at § 623(b)(7)(A). A cable operator is free to add additional programming to its BST. *Id.* at § 623(b)(7)(B).

[6] *Id.* at §§ 623(b)(2)(B), 623(c).

[7] *Id.* at § 623(l)(2).

[8] *Id.* at § 623(b)(1).

and changes in the number of programming channels).[9] The 17% competitive differential represented the average difference that the Commission determined existed between the rates of competitive and noncompetitive systems.[10]

4. In adopting the benchmark methodology, the Commission sought to avoid the significant administrative and compliance costs that often result from using the cost of service methodology that is traditionally applied to public utilities. At the same time, we recognized that the benchmark approach might not produce fully compensatory rates in all cases. Therefore, we decided to permit operators to establish rates based on costs pursuant to individual cost of service showings.[11] Thus, the cost of service rules provide a safety valve for operators that are unable to generate reasonable revenues under the primary benchmark mechanism.[12]

5. When we adopted our first order implementing the rate regulation provisions of the 1992 Cable Act, we found that the record did not contain sufficient information to enable us to develop detailed cost of service rules properly tailored for the cable industry.[13] Therefore, pending the adoption of specific rules pursuant to a further rulemaking, we said that in lieu of the benchmark approach, operators could make individual cost showings that would be subject to case-by-case review. We subsequently issued the initial Notice of Proposed Rulemaking in this docket ("*Cost Notice*") seeking comment on specific regulatory requirements to govern cost of service showings.[14]

6. Based on the comments filed pursuant to the *Cost Notice*, we adopted the Report and Order and Further Notice of Proposed Rulemaking ("*Cost Order*" or "*Further Notice*"), implementing a cost of service alternative to the benchmark approach.[15] In general,

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[9] *See* Second Order on Reconsideration, Fourth Report and Order and Fifth Notice of Proposed Rulemaking ("*Second Reconsideration Order*"), MM Docket No. 92-266, FCC 94-38, 9 FCC Rcd 4119, 4124 (1994), *aff'd in pertinent part Time Warner Entertainment Co., L.P. v. FCC*, 56 F.3d 151 (D.C. Cir. 1995), *reh'g den.* (July 17, 1995).

[10] *Id.*

[11] Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-177, 8 FCC Rcd 5631, 5794 (1993) ("*Rate Order*").

[12] *Id.*

[13] *Id.* at 5799.

[14] Notice of Proposed Rulemaking, MM Docket No. 93-215, FCC 93-353 (1993).

[15] Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 93-215 and CS Docket No. 94-28, FCC 94-39, 9 FCC Rcd 4527 (1994).

these cost rules are designed to permit a cable operator to recover its operating expenses and a fair return on its investment, while protecting subscribers from unreasonable rates. Deciding the precise manner in which operators must calculate the three major variables -- expenses, rate of return, and ratebase -- raises numerous issues that we discuss with specificity in the following summary and in the individual sections which address particular aspects of the interim rules.

II. INTERIM COST OF SERVICE RULES - GENERALLY

A. Background

7. In the *Cost Order*, we specified the principles that would guide our disposition of cost of service filings by operators seeking to justify rates independent of the benchmark approach, pending adoption of final cost of service rules. Many of the rules to be followed by cable operators making cost of service showings are presumptive only, and thus may be rebutted by operators making cost of service filings depending upon the circumstances of the individual case. This ensures that high-cost systems are able to recover their actual cost of providing regulated service. We articulated interim rules with respect to recovery of costs across all significant categories, measurement of the ratebase used to determine the return on invested capital, the proper rate of return, and all expenses associated with the provision of regulated services. Generally, the interim rules permit a cable operator to establish rates that will allow it to recover a fair return on its investment, or ratebase, plus all of its reasonable operating expenses.

8. The largest portion of an operator's ratebase is its plant in service. Under the interim rules, an operator may include in its ratebase only that portion of plant representing prudent investment and that is used and useful, since this portion of the plant directly benefits subscribers.[16] We said that valuation of the plant should be measured based on the original cost of the equipment, rather than by the market value, replacement cost, or some other approach.[17] Subject to certain restrictions, the ratebase also may include accumulated start-up losses[18] and investments associated with three categories of intangible assets: organizational costs, franchise costs, and customer lists.[19] We generally limited start up losses to losses incurred in the first two years of operation.[20] Under the *Cost Order*, plant under construction is excluded from the ratebase, but operators may calculate an allowance for

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[16] *Id.*, 9 FCC Rcd at 4546-47.

[17] *Id.* at 4554-55.

[18] *Id.* at 4563-65.

[19] *Id.* at 4576-77.

[20] *Id.* at 4564.

funds used during construction which may be included in the ratebase when the plant is placed into service.[21] Operators may also include in the ratebase certain amounts attributable to excess capacity that the operator intends to use within 12 months and cost overruns.[22]

9. Although an operator's ratebase must reflect the depreciated value of its assets, we did not prescribe specific depreciation rates or schedules in the *Cost Order*. Instead, we said that depreciation rates claimed by operators would be subject to case-by-case review.[23]

10. With respect to the return allowed on the ratebase, we provided a presumptive overall after-tax rate of return of 11.25%.[24] This is a presumptive unitary rate; any party seeking a different after-tax rate may rebut the presumptive 11.25% rate by showing that a different rate is warranted given the particular circumstances of the operator in question. We applied the discounted cash flow method to determine the cost of equity, using the third quartile of the Standard & Poor's 400 stock index ("S&P 400") as a surrogate for regulated cable service.[25] With respect to debt cost, we estimated an average debt cost for the industry of 8.5%.[26] Using a capital structure range of 40% to 70% debt, we developed a range of total capital costs and selected a rate toward the higher end of this range; the resulting figure was 11.25%.[27]

11. As noted, the interim rules also allow the operator to recover all operating expenses normally incurred by cable operators in the provision of regulated cable service. An operator may not recover through regulated rates other expenses, such as costs associated with nonregulated services, lobbying expenses, or club memberships.[28] However, recoverable operating expenses do include depreciation expense[29] and an amount to allow for

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[21] *Id.* at 4586.

[22] *Id.* at 4592-93.

[23] *Id.* at 4603-04.

[24] *Id.* at 4635.

[25] *Id.* at 4623-27.

[26] *Id.* at 4628.

[27] *Id.* at 4631-35.

[28] *Id.* at 4597-98.

[29] *Id.* at 4603-04.

taxes on the provision of regulated service.[30]

12. In calculating its ratebase and operating expenses, the operator must use data from its most recent fiscal year.[31] The operator must adjust these "test year" data for known and measurable changes that have occurred by the time the rates take effect.[32]

13. In the *Cost Order*, we stated our intent to adopt a uniform accounting system for those cable operators electing cost of service regulation.[33] We concluded that a uniform accounting system would simplify cost of service proceedings and ensure accurate reporting.[34] Therefore, we proposed and sought comment on an accounting system we felt was workable and reliable.[35] Until a uniform system of accounts can be finalized, operators electing cost of service regulation are required to use an interim summary accounting system, as set forth in FCC Forms 1220 and 1225.[36] To ensure that subscribers to regulated services pay only for the cost of those services, we require operators to allocate costs among basic and cable programming service tiers, nonregulated programming services, other cable activities, and non-cable activities.[37]

14. In developing the interim rules, we recognized the potential for abuse of the cost of service scheme through affiliate transactions.[38] Accordingly, we promulgated rules for valuing transactions between cable operators and affiliated companies designed to prevent favorable self-dealing between affiliated companies which could distort the magnitude of costs recoverable in regulated rates. In general, the price of assets or services conveyed by a cable operator to an affiliate, or from the affiliate to the cable operator, must be based on the price at which the provider has sold the same kind of asset or service to a substantial

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[30] *Id.* at 4607-10.

[31] *Id.* at 4612.

[32] *Id.*

[33] *Id.* at 4641.

[34] *Id.* at 4641-45.

[35] *Id.* at 4681-83.

[36] *Id.* at 4643-44.

[37] *Id.* at 4650-51.

[38] *Id.* at 4663-64.

number of third parties.[39] If such a "prevailing company price" cannot be calculated for a service, then its price shall be based on the provider's cost.[40] Absent a prevailing company price for an asset, the price is the higher of net book cost and estimated fair market value when the operator is the seller, and the lower of those two amounts when the operator is the buyer.[41]

15. Apart from the standard cost of service showing, the *Cost Order* established other mechanisms by which operators can establish or adjust rates. First, to ease regulatory burdens for smaller cable systems, we developed a streamlined cost of service scheme exclusively for their use.[42] Second, an operator that has established rates in accordance with our benchmark approach may make an abbreviated cost of service showing that permits a rate adjustment reflecting solely the cost of a significant upgrade to the cable system.[43] This approach encourages operators to make upgrades that will return benefits to subscribers, but without forcing the operator to make a full-fledged cost of service showing in order to cover the cost of the upgrade. A third alternative approach provides for hardship rate relief for any operator that can demonstrate that neither the benchmark nor cost of service rules generate revenues necessary for its continued operation, despite prudent and efficient management.[44] Finally, the *Cost Order* introduced the concept of the upgrade incentive plan, intended to encourage the deployment of new technologies and services, promote operating efficiencies, and increase penetration. Pursuant to such a plan, an operator planning an upgrade to its system would be given substantial flexibility with respect to pricing of new services, in return for which subscribers would be guaranteed reasonable and stable rates for existing services.[45]

16. The cost rules and other requirements set forth in the *Cost Order* were adopted on an interim basis. As we introduced those rules, we simultaneously adopted the *Further Notice of Proposed Rulemaking* requesting comment on our proposal to adopt the interim rules on a permanent basis.[46] The *Further Notice* also proposed a productivity factor

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[39] *Id.* at 4665-66..

[40] *Id.*

[41] *Id.*

[42] *Id.* at 4671-72.

[43] *Id.* at 4674-75.

[44] *Id.* at 4676-77.

[45] *Id.* at 4677-80.

[46] *Id.* at 4681.

that could be incorporated into the price cap mechanism that governs rate adjustments.[47] We also specifically sought comment on rate of return prescription methodologies,[48] on a uniform accounting system for cable operators,[49] and on rules applicable to affiliate transactions.[50]

17. In adopting these interim rules, we stated that our cost of service requirements are designed "to produce rates that approach as closely as possible those that would evolve in a competitive market, while still allowing the operator of a high-cost system adequate recovery."[51] Rates determined by the cost of service rules are more reflective of the cost experience of the particular operator than are rates established through the benchmark rules, which are based not on costs but rather on an evaluation of rates charged by a broad spectrum of systems.[52] Thus, while both the benchmark and the cost of service methodologies seek to achieve competitive rates, they do so by different approaches, "one based on observed prices of cable systems, one based on actual costs."[53]

B. Comments[54]

18. Cable operators contend that the 1992 Cable Act prohibits traditional common carrier regulation of the cable industry and that the Commission's interim cost of service rules violate this command by burdening the cable industry with common carrier regulation.[55] These commenters further assert that the proposed rules are equally at odds with the legislative command that the Commission adopt an administratively simple regulatory

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[47] *Id.* at 4686-89. We subsequently rejected this proposal. Memorandum Opinion and Order, MM Docket No. 93-215, FCC 94-226, 9 FCC Rcd 5760 (1994).

[48] *Id.* at 4681.

[49] *Id.* at 4681-83.

[50] *Id.* at 4683-86.

[51] *Id.* at 4536.

[52] *See Second Reconsideration Order*, 9 FCC Rcd at 4153.

[53] *Id.*

[54] The comment summaries contained in this item incorporate filings received pursuant to the *Further Notice* as well as petitions for reconsideration, and associated responses and replies, from the *Cost Order*.

[55] Time Warner Comments at 4; TCI Comments at 3-6.

scheme.[56] Cable operators vigorously oppose any suggestion that the Commission establish so-called "regulatory parity" between cable operators and telephone companies, based upon congressional intent as well as on differing characteristics of the cable and telephone industries.[57]

19. Continental Cablevision, Inc. ("Continental"), for example, identifies distinctions between telephone companies and cable operators, stressing among other things the larger revenues, consistent payment of dividends, and the greater passing and penetration rates of the former.[58] Continental also argues that telephone companies have not encountered anything comparable to the substantial increase in the number of cable programmers in recent years, a development that has greatly increased operators' need for capital to fund upgrades needed to accommodate the additional programming.[59] Continental describes telephone technology as being heavily focused on switching, multiplexing, and call routing and notes that consumer demand can vary significantly during different parts of the day. Cable operators, on the other hand, must concentrate on capacity, due to the bandwidth requirements of video, and on consistent operations throughout the day, according to Continental.[60] Continental states that telephone and cable companies also differ in that the former have what Continental says are effectively "perpetual franchises," while a cable operator faces the threat of the termination of its business at the end of a franchise term that can be as short as five years.[61] To the extent the Commission is inclined to pursue regulatory parity as a goal, Continental urge the issuance of a notice of inquiry to ensure that we act on the basis of a record that accurately reflects the state of the telecommunications industries.[62]

20. Time Warner Entertainment Company, L.P. ("Time Warner") argues that the Commission's failure to recognize the exceptionally limited role that costs may play, i.e., as a safety net rather than a full regulatory alternative, has created a regulatory scheme that exceeds the Commission's jurisdiction.[63] First, Time Warner suggests that the Commission has relied on the availability of a cost of service alternative as a justification for

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[56] Time Warner Comments at 6; TCI Comments at 3-6.

[57] Time Warner Comments at 11-15; TCI Comments at 11-13.

[58] Continental Reply Comments at 4-5; *see* Time Warner Comments at 11-16.

[59] *Id.* at 5.

[60] *Id.* at 7-8.

[61] *Id.* at 8-9.

[62] *Id.* at 17.

[63] *Id.* at 8.

what Time Warner deems to be a "draconian" benchmark formula.[64] Second, Time Warner argues that the Commission's failure to consider the allegedly limited utility of cost based regulation has resulted in extending the uniform system of accounts, affiliate transaction rules and other cost based regulations to benchmark-electing companies.[65] Third, Time Warner argues that traditional cost-based regulation is backward and inefficient and thus unsuitable for the high-growth cable industry.[66] Finally, Time Warner argues that the Commission's proposal to adopt the cost of service interim rules as permanent rules is at odds with Congress' intention that cable rate regulation be implemented on a transitional basis, i.e. until effective competition is established.[67] Likewise, Tele-Communications, Inc. ("TCI") argues that because the proposed cost of service rules are rigid and of a public utility-style, they are inappropriate as a backstop mechanism for transitory price regulation of a dynamic industry.[68]

21. Comcast Cable Communications, Inc. ("Comcast") labels the interim rules a "cynical sham."[69] Comcast accuses the Commission of having "full knowledge" at the time it adopted the interim rules that they would "offer no relief whatever" to cable operators.[70] Comcast claims that in fashioning the rules, the Commission "reflexively and irresponsibly chose as its model traditional public utility regulation, a model suited only to mature industries from which cable differs in many respects."[71] In particular, Comcast argues that the Commission's restrictions on cost recoveries interfere with operators ability to earn a return for the benefit of investors and lenders that provided capital to cable operators in an unregulated environment.

22. Telephone companies generally support our proposal to adopt the interim rules on a permanent basis.[72] GTE Service Corporation ("GTE"), for example, describes the interim rules as "a balanced and reasonable means for cable operators facing

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64 *Id.*

65 *Id.* at 9.

66 *Id.* at 9-10.

67 *Id.* 10-11.

68 *Id.* at 7-10.

69 Comcast Petition at 4.

70 *Id.* at 5.

71 *Id.* at 10.

72 *See*, *e.g.*, GTE Comments at 4-5.

extraordinary circumstances or substantial underearnings to establish fair cost-based rates."[73] GTE opposes relaxation of the presumptions contained in the interim rules and urges us to affirm that the benchmark approach should serve as the primary rate setting methodology.[74] GTE states that the Commission's interim rules provide more than an adequate opportunity for operators to justify inclusion of any costs in regulated rates because they are free to rebut presumptively disallowed costs on an individual case basis, or in hardship showings to the extent that such operators establish that their costs ultimately benefit subscribers and resulting rates are not above competitive levels.[75]

23. Telephone companies argue that cable operators are wrong in asserting that the Commission should not work towards regulatory parity between the cable and telephone industries. BellSouth Corporation ("BellSouth") warns that regulatory parity is necessary "to avoid artificially favoring or handicapping one competitor over another as cable companies move into increasingly direct competition with telephone companies -- both in the consumer market and in capital markets where they compete for investor dollars."[76] While acknowledging that our rules should take account of "legitimate differences" between the cable and telephone industries, Bell Atlantic Telephone Companies ("Bell Atlantic") states that regulatory parity is the "natural policy outgrowth" of the convergence of the cable and telephone industries.[77] In addition, Bell Atlantic argues that the 1992 Cable Act requires the Commission to establish regulatory parity between the cable and telephone industries because the principal goal of the 1992 Cable Act is to encourage competition from alternative and new technologies.[78]

24. Bell Atlantic contends that differences between the two industries described in the comments of cable operators do not justify "preferential regulatory treatment" of cable.[79] For example, the absence of rate regulation for most of the history of cable television simply reinforces the need for strict regulation, Bell Atlantic suggests.[80] Failing to achieve regulatory parity will hamper efforts by telephone companies to compete with cable,

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[73] GTE Comments at 4.

[74] GTE Response to Petitions at 6-7.

[75] *Id.*

[76] Bell Atlantic Reply Comments at 3.

[77] Bell Atlantic Comments at 3; *see* US West Reply to Petitions at 1-3.

[78] *Id.* at 6-9.

[79] *Id.* at 4.

[80] *Id.* at 5.

in contravention of Congress' goal of encouraging such competition, according to Bell Atlantic.[81] TCI responds that in fact cable companies and telephone companies "do not provide services in competition with one another, making 'parity' a superficially attractive but nevertheless substantively irrelevant policy objective."[82] TCI claims that state laws continue to protect many telephone companies from competition.[83]

C. Discussion

25. We believe the argument that the interim cost of service rules conflict with congressional intent too narrowly construes the actual intent of Congress. We reiterate that our primary approach to rate regulation for cable services is the benchmark approach. That approach does not replicate Title II regulation and is thus consistent with congressional intent. Cable operators are not required to use the cost of service methodology at all; it is a safety valve approach. Moreover, our cost of service rules do not replicate Title II regulation because they impose fewer regulatory burdens than their common carrier counterparts. For example, common carriers are subject to more comprehensive rules with respect to systems of accounting and more detailed rules with respect to cost allocations, filing requirements, and universal service. Indeed, the comments from telephone companies, arguing for more "regulatory parity" between the telephone and cable industries, evidence the substantial differences between our cable cost of service rules and common carrier regulation.

26. In considering the issue of regulatory parity, or any other issue, we must remain faithful to the intent of Congress as expressed in the 1992 Cable Act. Our mandate under that statute was to adopt regulations that ensure the reasonableness of the rates charged to subscribers of systems that are not subject to effective competition[84] while minimizing the regulatory burdens imposed upon all parties, including cable operators and local franchising authorities.[85] To satisfy these sometimes conflicting goals, Congress dictated several rules of general applicability. For example, in fashioning rules the Commission must consider such factors as the cost of obtaining and transmitting certain types of programming, franchise fees, taxes, and a reasonable profit for cable operators.[86] Our cost of service rules take account of these factors and hence follow the dictates of the 1992 Cable Act.

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[81] *Id.* at 6, citing H.R. Rep. No. 628, 102d Cong., 2d Sess. 27 (1992).

[82] TCI Reply Comments at 8.

[83] *Id.* at 8-9.

[84] Communications Act § 623(b)(1) (regulation of basic tier rates); Communications Act § 623(c)(1) (regulation of cable programming services).

[85] Communications Act § 623(b)(2)(A).

[86] Communications Act § 623(b)(2)(C).

27. Apart from these specific requirements, however, Congress granted the Commission the discretion to "adopt formulas or other mechanisms and procedures in complying" with its duties under the Communications Act.[87] In crafting these provisions, the overriding intent of Congress was to ensure that the Commission had the flexibility it needed to address the many considerations that Congress knew the Commission would face in adopting a regulatory scheme to govern rates charged by cable operators:

> Rather than requiring the Commission to adopt a formula to set a maximum rate for basic cable service, the conferees agree to allow the Commission to adopt formulas or other mechanisms and procedures to carry out this purpose. The purposes of these changes is to give the Commission the authority to choose the best method of ensuring reasonable rates for the basic service tier and to encourage the Commission to simplify the regulatory process.[88]

28. There are sound reasons for the similarities between the regulation of telephone companies and that of cable operators. The two industries share physical and technical similarities. Moreover, our regulation of both industries has identical goals: to protect consumers from unreasonable rates while allowing for a reasonable return for the service provider. In view of these circumstances, we believe that some parallel treatment of cable operators and telephone companies is inevitable. By the same token, as highlighted by Continental, differences between the industries require the adoption of distinctive regulatory schemes in some instances. We believe this is the approach mandated by Congress and reflected in both our interim and our final cost rules.

29. We understand Time Warner to argue that rules regarding affiliate transactions and uniform accounting system effectively apply to benchmark operators, to the extent the operators anticipate ever making a cost of service of filing, since they deem it necessary to adjust their books now in accordance with such rules. In view of our decision, *infra*, not to adopt a uniform system of accounts, this concern is limited to the burden of maintaining books that accurately reflect affiliate transactions. Even assuming a cable operator decides to change its accounting methods for this reason, we do not believe that the voluntary decision of a cable operator to make certain adjustments in its accounting system equates to the imposition of accounting requirements, much less the imposition of the full panoply of Title II requirements.

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[87] Communications Act § 623(b)(2)(B).

[88] H. Rep. 862, 102d Cong., 2d Sess. 62 (1992). While this language refers in particular to basic tier regulation, Congress did not express an intent to grant any less discretion to the Commission with respect to CPST regulation.

30. Although Comcast suggests that the interim cost of service rules would put operators out of business, it offers no proof to back up this assertion. We have justified our interim rules, and now the final rules, in accordance with well-accepted regulatory principles, deviating as necessary to accommodate the peculiar characteristics of the cable industry. In addition, most of the cost rules are applied on a presumptive basis only, thus giving an individual operator an opportunity to justify a treatment different than strictly applying the presumptive rules. In sum, we find no support in the record for Comcast's unsubstantiated assertions regarding the adequacy of the interim rules.

III. RATEBASE -- USED AND USEFUL PLANT AND EXCESS CAPACITY

A. Background

31. As the Commission stated in the *Cost Order*, under traditional ratebase/rate of return principles, it is necessary to determine the allowable ratebase in order to calculate the return or profit component of the revenue requirement.[89] The largest component of the ratebase is "plant in service." The interim cost rules state that to be included as part of "plant in service," plant must be "used and useful in the provision of cable service," and must be the result of prudent investment.[90] The used and useful standard thus prohibits the inclusion of the cost of plant in ratebase unless the plant is in operation and providing direct benefits to subscribers. A related concept is that of excess capacity. Excess capacity is plant which has been built but is not currently used and useful.

32. For valuating plant under construction for ratebase purposes, we adopted the capitalization method. Thus, an operator must exclude plant under construction from the ratebase, but may calculate an allowance for funds used during construction ("AFUDC") and include this allowance in the cost of construction.[91] AFUDC is accrued at a rate based on the actual cost of debt.[92] As construction is completed and the plant placed into service, the cost of construction, including AFUDC, is included in the ratebase and recovered through depreciation.[93]

33. In adopting the interim rules the Commission stated that the used and useful standard would ensure that subscribers pay for only those portions of plant that are

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[89] *Cost Order*, 9 FCC Rcd at 4545.

[90] *See* 47 C.F.R. § 76.922(g)(6)(i).

[91] *Cost Order*, 9 FCC Rcd at 4586.

[92] *Id.* at 4586, n. 204.

[93] *Id.* at 4586.

used and useful in the provision of regulated cable services.[94] The Commission intended that applying the used and useful standard together with the prudent investment standard would achieve a fair balance of consumer and investor interests in determining regulated cable service rates under our cable cost of service standards. In addition, the standard is the same as that which the Commission has applied to telephone companies, and thus was expected to be simple to apply and to administer.[95] The *Cost Order* also concluded that excess capacity could be included in ratebase if it would be used and useful within one year.[96]

B. Comments

34. Continental asks the Commission to clarify that used and useful plant is 100% of energized plant that is actually used to send signals to customers or will be used within one year, claiming that it would be arbitrary and unreasonable not to allow the operator to include all of the cost of the plant in the ratebase simply because the system can carry programming on more channels than are actually activated. Continental also asks the Commission to clarify that all of this plant must be allocated among regulated and unregulated service baskets based on a reasonable measure of the current usage of that plant.[97]

35. Viacom International, Inc. ("Viacom") suggests that the Commission include in ratebase any excess capacity that will be used within a 24 month period, asserting that the 12 month period is unreasonably short because a prudent cable operator will always design the construction project to include a reasonable amount of excess capacity in order to meet expected but not yet current demand. According to Viacom, the Commission's interim rule provides cable operators with an incentive to make significantly smaller upgrades, which may make it necessary for operators to make upgrades more frequently, resulting in consumers having to pay higher prices.[98]

C. Discussion

36. In general, except as described below, we make permanent our interim rules regarding ratebase issues. In response to Continental's request, we clarify that used and useful plant is plant that is actually used to send signals to customers. Plant which is not currently used and useful, however, is excess capacity, and operators may include this excess capacity in the ratebase only if it is fully constructed plant that will be used to provide

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[94] *Cost Order*, 9 FCC Rcd at 4547.

[95] *Id.*

[96] *Id.* at 4592.

[97] Continental Comments at 29-32.

[98] Viacom Comments at 11-13.

regulated service within 12 months. The Commission clarifies that there are two types of excess capacity. First, where plant is being used but not to its full capacity, the portion of the plant allocated to the unused channels is excess capacity. For example, where a system provides programming over 36 channels but is capable of transmitting 48 channels of programming, the plant associated with the 12 channels not currently being used is excess capacity. In other words, in this example, the operator may only include 75% of the cost of the plant in the ratebase as used and useful plant, and may include the other 25% as excess capacity only if the 12 channels will be activated within one year. Second, excess capacity is fully constructed plant that is not being used at all, such as where the cable operator has extended its distribution line into an unserved portion of the franchise area, is ready and able to provide service to that area, but is not yet providing such service.[99] The operator may include such plant in its ratebase to the extent it intends to place the plant into service within 12 months. However, the operator must make a corresponding adjustment to its subscriber count to include a reasonable estimate of the number of subscribers it expects to serve with that plant by the end of the 12 month period.

37. The Commission also clarifies that plant in service must be allocated between regulated and unregulated services based on a reasonable measure of the current usage of that plant. Section 76.922(g)(6)(i) of our rules[100] currently uses the phrase "used and useful in the provision of cable services," but does not specify that such cable services must be regulated cable services. Since our authority to determine cable rates extends only to regulated services as defined by the Communications Act,[101] only plant used and useful in the provision of regulated services should be included in the ratebase. Accordingly, for our final rules, we will make this point explicit and will amend the interim rule to specify that tangible plant must be used and useful in the provision of regulated cable services in order to be included in the ratebase. This will ensure that the ratebase for regulated cable service only includes plant used for such regulated cable service, and that subscribers to regulated tiers are not forced to subsidize plant that is used solely for premium services.

38. In addition, we recognize that what constitutes a reasonable measure of the current usage of the tangible plant depends on the circumstances. We believe that in many cases a reasonable measure would be a straight channel ratio. In other words, if an operator provides programming over a total of 40 channels, 32 of which are BST and CPST channels and eight of which are premium and pay-per-view channels, the operator must allocate 80% of its plant in service to regulated cable service and 20% to unregulated service. We do not believe, however, that the channel ratio should be weighted by customer. The cost of physical plant is directly related to the provision of cable channels and the amount of channel capacity a particular cable system has. The cost of that plant does not vary

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[99] Note, however, that excess capacity does not include plant under construction.

[100] 47 C.F.R. § 76.922(g)(6)(i).

[101] Communications Act, § 623(a)(2).

depending on how many subscribers receive each channel. It would be inappropriate to weight the channel ratio by subscriber use when such use does not affect the cost of the plant.

39. Furthermore, we deny Viacom's request that we extend from 12 months to 24 months the time period within which excess capacity must be used and useful in order to be included in ratebase. For business purposes, operators commonly project how much capacity will be used within the given year as part of their annual operating budgets. We believe that the 12 month period therefore permits plant associated with all reasonably foreseeable improvements in or additions to service to be included in ratebase. Allowing inclusion of excess capacity which is not expected to be used within the coming year increases the likelihood that current customers would pay for plant from which they may never enjoy the benefits. In addition, we believe that even a good faith prediction that plant will be used and useful within 24 months is too speculative to permit associated costs to be included in the current ratebase. For these reasons, the Commission adopts the interim one year rule as its final rule.

IV. RATEBASE - INTANGIBLES

A. Background

40. When a cable operator purchases an existing cable system, the purchase price often exceeds the book value of the tangible assets (the initial cost of the assets minus any depreciation). This was particularly true of transactions consummated prior to implementation of the 1992 Cable Act. At that time, the absence of rate regulation presumably would have increased the overall value of any particular cable system, but would have had no effect on the book value of the tangible asset. Thus, the increased value attributable to a lack of regulation would have to be allocated to intangible assets. Previously, we have termed the amount paid for the system above the book value of the plant "excess acquisition cost."[102] For accounting purposes, the excess of the purchase price over the book value of the assets is typically recorded as "intangibles" or "goodwill."

41. There are many reasons that a prudent business person might pay more than the book value of the plant for a cable system. For example, a prudent business person might also be willing to pay more than the book value of the assets because of efficiencies the purchaser might bring to the acquired system as part of a larger multisystem operator ("MSO"). Thus, a system purchaser could reasonably allocate a part of the purchase price to start up losses and expect to recover this expense from subscribers, to the extent such costs were necessary to establish a system capable of providing regulated services to subscribers.[103]

[102] *Cost Order*, 9 FCC Rcd at 4566.

[103] Such assets are usually recorded as "goodwill" and as such would not generally be allowed as part of ratebase. To the extent that such costs were recorded as start-up losses,

42. On the other hand, a purchaser might be willing to pay a higher price in expectation of monopoly profits. Traditional principles of rate of return regulation prohibit a business from including in its ratebase goodwill or other intangible costs that represent monopoly expectations.[104] Likewise, excess acquisition costs attributable to an expectation of revenues from unregulated services, or that simply were the result of improvident business decisions, generally should not be included in the ratebase, since to do otherwise would result in subscribers of regulated services subsidizing investments from which they are not reasonably likely to receive a benefit.

43. In the *Cost Order*, we distinguished between intangible costs on which operators presumptively were entitled to a return on their investment and intangible costs on which operators presumptively were not entitled to a return on their investment from subscribers to regulated services.[105] Intangible costs which were legitimately necessary in order to allow the operator to provide regulated service to subscribers, and thus were incurred in order to benefit subscribers to regulated services, were recognized as presumptively includable in the regulated ratebase.[106] We recognized organizational costs, franchise costs and customer lists as presumptively permissible, subject to certain restrictions.[107]

44. Organizational costs represent the costs of establishing the legal business entity.[108] These costs were incurred to provide benefits to subscribers and should be included in the ratebase.[109] Franchise costs represent the cost of acquiring the franchise rights through direct transaction with the franchising authority by the original system owner and are likewise includable in the ratebase.[110] For acquired systems, franchise costs represent any unamortized franchise costs on the books of the seller. Customer lists may also be included in the ratebase

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they would be allowed.

[104] Charles F. Phillips, Jr., *The Regulation of Public Utilities* 351 (1993).

[105] *Id.* at 4575-84. Presumptively impermissible intangible costs would not be included in the ratebase and could not be recovered as part of the rates for regulated services. However, we noted that such intangible costs could be recovered from rates for unregulated services.

[106] *Id.* at 4575-76. We also noted that such costs would most likely be incurred even if the services were provided in a competitive environment.

[107] *Id.* at 4576-77.

[108] *Id.*

[109] *Id.*

[110] *Id.* at 4577.

to the extent that they reflect costs capitalized during prematurity, as defined by FASB 51,[111] and are useful in the provision of regulated cable service.[112] Customer lists consist of the active accounts that the purchaser takes over when it acquires the system. The acquiring system may include in its ratebase a cost attributable to customer lists to the extent that subscribsership development costs are avoided at acquisition. Other intangible costs associated with the acquisition of a cable system are generally presumed to be excluded from the ratebase.[113]

B. Comments

45. Cable operators oppose our treatment of most intangible costs in the interim rules. Their arguments generally fall into one of two categories. Some commenters maintain that all costs allocable to intangible assets should be included in the ratebase.[114] These commenters argue that such costs originated in arms-length transactions entered into in good faith in an unregulated environment. According to these commenters, exclusion of these assets from the ratebase would constitute an impermissible taking without just compensation in violation of the Fifth Amendment to the United States Constitution. Other commenters begin by arguing that all intangibles should be included in the rate base, but go on to argue in the alternative that while intangible costs may include some expectation of monopoly profits and should be excluded from the ratebase, these excludable intangible assets must be distinguished from legitimate intangible assets.[115] These commenters propose various methods to separate legitimate intangible costs from those which should not be included in the ratebase.

46. TCI argues that the presumptive disallowance of excess acquisition costs from ratebase is based on an incorrect assumption that acquisition prices represent amounts

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[111] FASB 51 refers to Statement of Financial Accounting Standards No. 51, Financial Reporting by Cable Television Companies. FASB 51 defines the prematurity phase during which a cable system is partially under construction and partially in service. In the prematurity phase, the operator must partially capitalize and partially expense costs related to current and future operations.

[112] *Id.* at 4577.

[113] *Id.* at 4578-84. However, we do allow operators to rebut the presumption that these intangible costs could not be included in ratebase. In making such a showing, the burden is on the operator to demonstrate that the costs benefitted subscribers to regulated services. *Id.* at 4583.

[114] *See, e.g.*, TCI Comments at 23-32; NCTA Comments at 29-32; Avenue TV Reply Comments at 3.

[115] *See, e.g.,* Continental Comments at 8-9; Viacom Comments at 8-11.

paid in expectation of supracompetitive profits, growth premiums for unregulated services and simple overpayments.[116] TCI claims that this presumptive disallowance ignores efficiency gains obtained through system acquisitions.[117] In addition, TCI states that the price paid to a seller of a cable system typically includes losses, earning deficiencies, and opportunity costs incurred by the seller.[118] TCI also notes that there is a real problem of documentation and quantification of amounts attributable to legitimate intangible assets because there were no business or accounting reasons for them to be separately valued and recorded at the time of the transaction.[119] Further, TCI asserts that the presumptive disallowance of intangibles is contrary to the Commission's conclusion that the 1992 Cable Act's objective is to set prices that reflect the costs of competitive systems because in a competitive market, prices will include a normal return on capital, including the acquisition of intangibles.[120] Accordingly, TCI proposes that the ratebase be the value of invested capital less depreciation reflected on the cable operator's existing audited books, subject to adjustment only where those books are inaccurate or incomplete.[121] TCI states that this would be analogous to the "fair value" approach to ratebase valuation common in the early part of this century.[122]

47. The National Cable Television Association ("NCTA") also opposes the exclusion of excess acquisition costs from the ratebase.[123] NCTA states that, at a minimum, all preregulation acquisition costs should be included in the ratebase.[124] NCTA argues that the Commission's decision to exclude excess acquisition costs from the ratebase was based on several erroneous assumptions.[125] First, NCTA states that any premium paid for a cable system before regulation did not necessarily reflect the expectation of monopoly profits but rather could have been the result of a variety of factors.[126] Second, NCTA argues that the

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[116] TCI Comments at 23-32.

[117] *Id.* at 26.

[118] *Id.* at 26-27.

[119] *Id.* at 28.

[120] *Id.* at 28-29.

[121] *Id.* at 30-32.

[122] *Id.* at 31.

[123] NCTA Comments at 29.

[124] *Id.*

[125] *Id.* at 30.

[126] *Id.*

Commission bases its decision to exclude certain acquisition-related assets on its view of traditional public utility concepts, but those concepts are simply not appropriate for an industry that has only recently been made subject to rate regulation.[127] NCTA also argues that excluding excess acquisition costs that were incurred prior to regulation may be violative of the basic tenet of law against retroactive ratemaking.[128] Avenue TV asserts that the proposed disallowance of intangible assets unfairly discriminates against older cable systems whose assets have been substantially depreciated.[129]

48. Continental and Viacom both argue that intangible should be included in ratebase but also offer alternative arguments. Continental urges that we reject the presumption against recognizing most intangible costs in the ratebase.[130] Continental argues that prices paid for cable systems appropriately reflect the real investments made in those systems, including investments represented by the prior owners' continuing efforts to develop and expand those systems over the long term despite recurring losses and low earnings.[131] Therefore, Continental recommends that 100% of the purchase price be allowed in the ratebase.[132] Viacom also opposes the Commission's presumptive exclusion of intangible assets from the ratebase because the record does not support any presumption or expectation that monopoly profits were the exclusive, or even the most likely, reason that cable systems were sold in excess of their book value.[133] Viacom asserts that the difference between competitive and historical costs is not a result of manipulation or expectation of monopoly rents, but a recognition of the true perceived value of the assets.[134]

49. As an alternative to its recommendation that we eliminate entirely our current presumptions concerning intangible costs, Continental suggests that where adequate documentation exists, the current owner can calculate an "accumulated return deficiency"

[127] *Id.* at 31.

[128] *Id.* at 32.

[129] Avenue TV Reply Comments at 3.

[130] Continental Comments at 3.

[131] *Id.* at 11-13.

[132] *Id.* at 13-15.

[133] Viacom Comments at 8-11.

[134] *Id.*

associated with the system just as the prior owner would.[135] Under another alternative, the Commission could develop or accept evidence relating to an "average schedule" of per-subscriber losses and low earnings that could reasonably be included as intangible assets in the ratebases of acquired systems.[136]

50. If it is not possible to develop an average schedule of subscriber losses, Continental recommends that the Commission disallow a limited portion of intangibles by using the economic analysis underlying the benchmark system.[137] Continental asserts that to the degree that a particular purchase price reflected an expectation of monopoly profits, that expectation would be limited by the cash flow of the particular system since cash flows are the primary basis for cable system valuations.[138] Because the usual ratio of revenues to cash flows is 2:1, Continental proposes applying the same ratio to determine the amount of a purchase price that might reflect an expectation of monopoly profits.[139] Under this proposal, the average 17% benchmark rate reduction would dictate a disallowance of acquisition-related intangibles equal to 34% of the gross purchase price of the system.[140] The remaining 66% -- comprising both tangible and intangible assets -- would be presumptively included in the ratebase.[141] To the extent that the Commission does not allow intangibles in the ratebase, Continental urges the Commission to allow operators to amortize these assets.[142]

51. Since Viacom believes that it is impossible to establish that no portion of a cable system's purchase price reflects monopoly rents, Viacom recommends that the Commission disallow a portion of goodwill.[143] Viacom proposes that the Commission presumptively exclude 10% of acquisition costs, determined on the basis of fair market value

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[135] Continental Comments at 8-9. *See infra* at ¶¶ 64-66 (discussion of accumulated return deficiency).

[136] *Id.* at n. 16.

[137] *Id.* at 4-5.

[138] *Id* at 4 (citing Declaration of Colleen Millsap).

[139] *Id.* at 4-5.

[140] *Id.* at 5.

[141] *Id.* at 6.

[142] *Id.* at 23-26.

[143] Viacom Comments at 8-11.

of the assets.[144]

C. Discussion

52. In the *Cost Order*, we presumptively excluded from the ratebase those costs commonly referred to as excess acquisition costs in this proceeding. Our reasoning there was that the prices paid for cable systems, especially during the period when those systems possessed market power, are not a reliable or reasonable basis for ratemaking.[145] Indeed, we concluded that one reason we should not rely on acquisition prices for ratemaking was that it appeared that those prices often include an expectation of supra-competitive profits that market power of cable systems not operating in a fully competitive market might expect to generate.[146]

53. We continue to reject the argument that operators are entitled to include 100% of their intangible costs in the ratebase. Contrary to commenters' arguments, exclusion of some amount of these costs from the ratebase does not result in an impermissible taking without just compensation in violation of the Fifth Amendment. As has been recognized by courts since the Supreme Court's decision in *Hope*,[147] establishing reasonable rates involves the balancing of consumer and investor interests.[148] Thus, there is a zone of reasonableness, bounded on the one end by investor interest against confiscation and at the other by consumer interest against exorbitant rates, within which rates must fall.[149] In determining whether rates are confiscatory, we must look at whether the rates established under a particular ratemaking methodology "jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." Moreover, we must consider whether the rates fail to compensate investors for the risk associated with their investments. However, the Court has made clear that it is "not theory but the impact of the rate order which counts."[150] Indeed, the Court stated that "fixing of prices . . . may reduce the value of the property being regulated. But the fact that the value is reduced does not

[144] *Id.* at 10.

[145] *Cost Order*, 9 FCC Rcd at 4578, para. 91.

[146] *Id.*

[147] *Federal Power Comm'n v. Hope Natural Gas Co.* 320 U.S. 591 (1943).

[148] *Id.* at 603.

[149] *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950), *cert.denied*, 340 U.S. 952 (1951).

[150] *Hope*, 320 U.S. at 602.